[JOINT COMMITTEE PRINT]

DESCRIPTION OF H.R. 3899 AND H.R. 3900

RELATING TO

SIMPLIFICATION OF INSTALLMENT SALE REPORTING RULES AND CERTAIN PROCEDURE AND ADMINISTRATION PROVISIONS UNDER THE INTERNAL REVENUE CODE

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON
SELECT REVENUE MEASURES

OF THE

COMMITTEE ON WAYS AND MEANS

ON JULY 27, 1979

PREPARED FOR THE USE OF THE

COMMITTEE ON WAYS AND MEANS

BY THE STAFF OF THE

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The bills described in this pamphlet (H.R. 3899 and H.R. 3900, introduced by Messrs. Ullman and Conable) have been scheduled for a hearing on July 27, 1979, by the Subcommittee on Select Revenue Measures of the Committee on Ways and Means. H.R. 3899 would amend the installment sale provision of the Code (sec. 453), and H.R. 3900 would amend subtitle F of the Code (certain procedure and administration provisions).

In connection with this hearing, the staff of the Joint Committee on Taxation has prepared for each amendment contained in the bills a description of present law, the issues involved, the bill provision, and, with respect to the bill relating to installment sale reporting, alternatives and additional issues which the committee may wish to consider. The pamphlet also includes the estimated revenue effect of the bills and the position of the Treasury Department with respect to the provisions of the bills.

(The five other bills—H.R. 2536, H.R. 2770, H.R. 3660, H.R. 4201, and H.R. 4276—also scheduled for the July 27 Subcommittee hearing are described in a separate pamphlet.)

I. SUMMARY

Simplification of the Rules Relating to Certain Installment Sales (H.R. 3899, Messrs. Ullman and Conable)

The bill (H.R. 3899) would amend the tax rules for reporting gains under the installment method for sales of real property and certain casual sales of personal property. (An identical bill, S. 1063, has been introduced in the Senate by Senators Long and Dole.)[1]

The bill would eliminate the requirement that no more than 30 percent of the selling price be received in the taxable year of sale to qualify for installment sale reporting for gains from sales of realty and casual sales of personal property. In addition, it amends the requirement that the selling price for casual sales of personal property must exceed $1,000 to qualify for installment sale reporting by increasing that amount to $3,000. The bill also provides that a sale will not be disqualified for installment sale reporting because the purchase price will be paid in a single lump sum amount in a year subsequent to the taxable year in which the sale is made. In addition, the bill provides that installment sale reporting is not available for sales between certain related parties. Finally, the bill makes it clear that any unreported gain from an installment obligation is to be recognized when the obligation is distributed or transmitted to the obligor.

Simplification of Certain Procedure and Administration Provisions (H.R. 3900, Messrs. Ullman and Conable)

The bill (H.R. 3900) contains amendments to the procedure and administration provisions of the Internal Revenue Code (subtitle F). The amendments are designed to improve the operation and administration of certain provisions of the tax laws. (An identical bill, S. 1062, has been introduced in the Senate by Senators Long and Dole.)[1]

The bill provides for (1) the payment of interest to a person whose property is wrongfully seized by the Internal Revenue Service, (2) the elimination of reporting requirements for certain transfers to exempt organizations, (3) the elimination of certain overlapping private foundation reporting, (4) repeal of the 25-percent penalty for certain jeopardy assessments, (5) the elimination of certain stock option information reporting to the Internal Revenue Service, (6) conforming the due date for gift tax and income tax returns and the granting of an automatic extension of time for filing certain gift tax returns when an extension for filing the donor's income tax return is granted, and (7) the disclosure of manufacturers excise tax information to State tax officials.

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[1] A public hearing was held on the Senate bill on June 22, 1979, by the Senate Finance Subcommittee on Taxation and Debt Management Generally.

II. DESCRIPTION OF H.R. 3899

(Messrs. Ullman and Conable)

SIMPLIFICATION OF THE RULES FOR CERTAIN INSTALLMENT SALES

A. Present Law

1. Installment sales generally

Generally, under present law (Code sec. 453), income from a sale of property on the installment basis may be reported as the payments are received. If elected for qualifying sales, the gain reported for any taxable year is the proportion of the installment payment received in that year which the gross profit, realized or to be realized when payment is completed, bears to the total contract price. In general, the contract price is the portion of the total selling price which will be paid to the seller.

The function of the installment method of reporting income is to permit the spreading of the income tax over the period during which payments of the sales price are received. Thus, the installment method alleviates possible liquidity problems which might arise from the bunching of gain in the year of sale when a portion of the selling price has not been actually received.

Under the installment sale provision, special rules are provided for dealers in personal property. The bill (H.R. 3899) does not relate to these dealer provisions but relates to the special provisions for sales of real property and casual sales of personal property. In general, the latter nondealer sales do not qualify for the installment method of reporting gain if the payments, other than evidences of indebtedness of the purchaser, received in the taxable year of the sale exceed 30 percent of the selling price. In addition, a casual sale of personal property must be for a selling price in excess of $1,000 to qualify for installment reporting.

2. Initial payment limitation

A number of problems have arisen in connection with the 30-percent initial payment requirement which was designed to limit installment sale reporting to transactions where hardships might result from current imposition of tax on uncollected amounts. Some have argued that it is an arbitrary limitation which has unduly complicated and interfered with normal business transactions.[1] In addition, it has been argued that the limitation has operated as a trap for the unwary. If a taxpayer fails to secure competent advice and inadvertently exceeds the 30-percent limitation, however slightly, the entire gain must be recognized in the year of sale.

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[1] The Section of Taxation of the American Bar Association has recommended repeal of the 30-percent requirement, Tax Section Recommendation No. 1978–15, 32 *Tax Lawyer* 231 (1978). Recently, the Federal Tax Division of the American Institute of Certified Public Accountants also recommended repeal of the requirement.

It is said that the limitation has produced an inordinate amount of litigation and confusion. In applying the 30-percent limitation, the problem areas necessarily involve interpretations of the terms "selling price" and "payment." Where the imputed interest provision applies (Code sec. 483), the limitation may not be satisfied if the selling price is reduced by the amount required to be treated as unstated interest (Treas. reg. § 1.453(b)(2)). Thus, after reduction of the selling price for unstated interest, the payments received in the year of sale may exceed 30 percent of the selling price although the limitation appeared to be satisfied on the basis of the written sales agreement. A similar disqualification can arise when the installment obligation is a corporate obligation issued at a discount because the amount treated as original issue discount is not included as part of the selling price (Treas. reg. § 1.453–1(b)(3)).

A number of problems may arise, or be exacerbated, because of the application of the 30-percent limitation in connection with the determination of the amount of payments received in the year of sale. In some limited situations, an unqualified right under the contract of sale to demand the balance of the purchase price has been regarded by the Internal Revenue Service as an initial payment (although the doctrine of constructive receipt would not appear to be applicable and the balance of the purchase price was not represented by a note payable on demand) (Rev. Rul. 55–694, 1955–2 C.B. 299). Thus, a contractual right to demand an additional part payment could be treated as a payment which causes the total payments in the year of sale to exceed 30 percent of the selling price. Another problem area involves the treatment of advance or escrow deposits as payment in the year of sale. Generally, if the seller is in actual or constructive receipt of the deposit, the amounts will be treated as payments for purposes of applying the 30-percent initial payment rule. In many of these situations, the problem relates to inadvertent disqualifications because of oversights in failing to take the deposit amounts into account for purposes of the 30-percent limitation rather than there being a question as to whether the amounts properly should be treated as received by the seller.

Another problem arises under present law in connection with the sale of property which is subject to an existing mortgage which is assumed by the installment buyer (or which is transferred to the buyer subject to an existing mortgage). Generally, the amount of the mortgage is taken into account as a part of the selling price but is not taken into account for purposes of determining the contract price or the amount of payments received by the seller. However, to the extent the mortgage exceeds the seller's basis in the property, the excess is considered as a payment received and correspondingly is included in the contract amount. (Treas. reg. § 1.453–4(c)). Again, the problem arising from this treatment does not involve its correctness but rather the inadvertent disqualification of the sale for installment method reporting for failing to take the amount of the mortgage in excess of basis into account for the 30-percent initial payment requirement. Where the taxpayers are cognizant of problems of this type, the 30-percent requirement has fostered ingenious "wraparound" mortgage arrangements to qualify for installment sale reporting.[2]

Under the wraparound arrangement, the buyer does not assume the mortgage and agrees not to make direct payments to the mortgagee but agrees to make the payments to the seller who will continue to pay the mortgage debt. In one case, the wraparound technique was used by having the seller retain title to the property for a period of years so there would be no transfer of property "subject to" the existing mortgage.[3] If title passes in the year of sale, the Internal Revenue Service will treat the mortgage debt in excess of basis as a payment received in the year of the sale.[4] This issue is said to be another instance of the 30-percent initial payment rule fostering uncertainty and litigation.

Another problem area relates to the treatment of selling expenses in determining if a payment is considered to be received to the extent that a mortgage assumed by the buyer exceeds the adjusted basis of the property sold. Under the regulations, commissions and selling expenses are taken into account as an offset to selling price for purposes of determining the gross profit from a sale by a nondealer (Treas. reg. § 1.453–1(b)), but do not reduce the amount of the payments, the total contract price, or the selling price (Treas. reg. § 1.453–4(c)). The consequence of this treatment may be illustrated by the following example. Assume that real property is sold on the installment basis for $1 million and that the seller incurs $25,000 in selling expenses. The seller's adjusted basis in the property is $200,000 and the property is subject to a mortgage of $510,000 which is assumed by the buyer. The contract price is payable in later years. Without taking the selling expenses into account, the payment considered received by the seller for assumed debt in excess of basis is $310,000 ($510,000 less $200,000) and, therefore, the sale will not qualify for installment reporting because that amount exceeds 30 percent of the selling price. However, the Ninth Circuit has held that selling expenses are to be added to basis for this purpose.[5] Thus, if in this example selling expenses of $25,000 are added to basis, the 30-percent initial payment limitation would not be exceeded by reason of the buyer's assumption of the mortgage. The amount considered to be received as a payment would be $285,000 ($510,000 less the sum of $200,000 and $25,000) and the sale would not be disqualified for installment sale reporting because up to $300,000 could be received in the taxable year of sale (30 percent of $1 million) under the initial payment limitation. The Internal Revenue Service has announced that it will not follow the Ninth Circuit's decision on the treatment of selling expenses.[6] Thus, this is another area where the 30-percent initial payment requirement may foster litigation and confusion.

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[2] Wyndelts and Campbell "Installment Reporting Need Not Be Lost When Year-Of-Sale Payments Are More Than 30%," 20 *Taxation for Accountants* 328 (1978); Ginsburg, "Taxing the Sale for Future Payment," 30 *Tax Law Review* 469, 488 (1975).

[3] *Stonecrest*, 24 TC 659 (1955) *nonacq*. 1956–1 C.B. 6.

[4] Letter rulings 7814010 and 7814011.

[5] *Kirschenmann v. United States*, 488 F.2d 270 (9th Cir. 1973).

[6] Rev. Rul. 74–384, 1974–2 C.B. 152.

Another problem area involves the case where the buyer pays off some of the seller's obligations in the year of sale. The Service has ruled that, in the case of a casual sale of personal property, the assumption and payment of secured and general unsecured liabilities by the purchaser will not be considered as a payment to the seller for installment sale reporting qualification purposes if the seller establishes that the liabilities were incurred in the ordinary course of business and not for purposes of avoiding the 30-percent initial payment limitation.[7] The avoidance test under the ruling would involve a subjective determination of motive. Thus, this is another area where the initial payment rule may foster litigation and confusion.

3. Two payment rule

Under present law, it is the position of the Internal Revenue Service that a taxpayer may not elect to report income from the sale of real property on the installment method where the total purchase price is payable in a lump sum in a taxable year subsequent to the year of sale.[8] The same issue may arise with respect to casual sales of personal property. The rationale for the ruling is that the installment concept generally calls for two or more payments of the purchase price in two or more taxable years and that a single payment sale cannot be considered to require payments in installments. The courts have agreed with the Service's interpretation.[9]

It has been argued that the two payment rule is a trap for the unwary and results in different tax results for transactions that are substantially similar.[10] For example, installment sale reporting would be available for a taxpayer who sells for a modest down payment with the balance due in 5 years but would not be available for a taxpayer who receives no down payment with the entire balance due in 5 years. In these situations, the ability to pay taxes from the sales proceeds is essentially the same. Thus, based on the underlying ability, or wherewithall, to pay rationale for installment sale reporting, it is argued that both sales should qualify.

Under the two payment rule, the entire gain for the single payment sale generally would be recognized in the year of sale. To avoid this result, taxpayers might argue that the buyer's obligation payable in several years has no ascertainable fair market value and it is not the equivalent of cash and, therefore, there is an "open transaction". If successfully argued, the gain is reportable when the proceeds actually received exceed the seller's adjusted basis in the property sold.[11] Although in most instances a deferred payment sale will not qualify under the open transaction doctrine, it is sometimes urged in inappropriate cases to avoid the results of the two payment rule. To this extent,

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[7] Rev. Rul. 73-555, 1973-2 C.B. 159.

[8] Rev. Rul. 69-492, 1969-2 C.B. 107, amplified by Rev. Rul. 71-595, 1971-2 C.B. 223. Recently, the Federal Tax Division of the American Institute of Certified Public Accountants recommended reversal of this rule.

[9] *Baltimore Baseball Club, Inc.* v. *U.S.*, 481 F.2d 1283 (Ct. Cl. 1973) ; *10-42 Corp.*, 55 T.C. 593 (1971).

[10] Ginsburg, "Taxing the Sale for Future Payment", 30 *Tax Law Review* 469, 483 (1975).

[11] *Burnet* v. *Logan*, 283 U.S. 404 (1931), is the leading case under the open transaction doctrine.

the two payment rule is said to foster unnecessary controversy or to encourage deliberate disregard of the law.

In the case of single deferred payment sales which are closed and reportable for the year of sale, it is necessary to determine, for the sale year, the present fair market value of the buyer's obligation to pay so that the gain reportable can be measured. In some situations, the valuation of the buyer's promise to make future payments may give rise to valuation disputes and controversy between taxpayers and the Internal Revenue Service. Such disputes are avoided under the statutory installment method since the purchaser's obligations generally are included at their face amount regardless of actual fair market value.[12]

In addition, even after a discounted value for the buyer's obligation is established as the selling price for a sale that does not qualify for installment reporting, the subsequent receipt of the contract amount in excess of the initial valuation of the obligation may be treated as income not arising from a sale or exchange, i.e., a "collection gain" is realized.[13] In the case of the sale of a capital asset under these circumstances, it is argued that treatment of the deferred single payment sale as being ineligible for installment sale reporting converts gain which should be reported as capital gain into a collection gain reportable as ordinary income. In the case of a sale which would qualify for installment reporting but for the two payment rule, collection gain treatment is pointed out as an additional harsh result from the application of the rule.

4. Sales to related parties

Under present law, the installment sale statutory provision does not preclude installment sale reporting for sales between related parties. Further, the statutory provision does not preclude installment sale reporting for sales of marketable securities although the seller might readily obtain full cash proceeds by market sales.[14]

Under the existing statutory framework, taxpayers have used the installment sale provision as a tax planning device for intra-family transfers of appreciated property, including marketable securities.[15] There are several tax advantages in making intra-family installment sales of appreciated property. The seller would achieve deferral of recognition of gain until the related buyer actually pays the installments to the seller, even if cash proceeds from the property are received within the related party group from a subsequent resale by the installment buyer shortly after making the initial purchase. In addition to spread-

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[12] *Frizzelle Farms, Inc.*, 61 T.C. 737 (1974) *aff'd per curiam* 511 F. 2d 1009 (4th Cir. 1075); *Mason* v. *U.S.*, 365 F. Supp. 670 (N.D. Ill. 1973), aff'd 513 F. 2d 25 (7th Cir. 1975).

[13] *Osenbach* v. *Comm'r*, 198 F. 2d 235 (4th Cir. 1952); *A. B. Culbertson*, 14 T.C. 1421 (1950), *acq.* 1950–2 C.B. 1; *Victor B. Gilbert*, 6 T.C. 10 (1946). This problem ordinarily will not arise if the installment obligation is owed by a corporate obligor (Code sec. 1232(a)).

[14] The receipt of the buyer's obligation payable on demand or readily tradable evidences of indebtedness is treated as the receipt of payment by the seller. For this purpose, readily tradable items include bonds and notes issued by a corporation or governmental unit with interest coupons attached or in registered form or in any other form designed to make the bond or note readily tradable in an established securities market.

[15] Another technique used for intra-family transfers involves the so-called "private annuity" arrangement. The bill does not deal with this type of arrangement.

ing out the gain recognized by the seller over the term of the installment sale, the seller may achieve some estate planning benefits since the value of the installment obligation generally will be frozen for estate tax purposes. Any subsequent appreciation in the property sold, or in property acquired by reinvestment of the proceeds from the property sold on the installment basis, would not affect the seller's gross estate since the property no longer belongs to him after the installment sale. (As discussed below, it has been argued that further tax savings can be achieved by giving or bequeathing the installment obligation to the obligor.) A nontax advantage available to the seller may be the opportunity to establish a fixed source of income, e.g., the installment payments would provide a regular source of cash income over the term of the installment sale.

With respect to the related buyer, there is virtually no tax to be paid if the appreciated property is resold shortly after the installment purchase. Since the buyer's adjusted basis is a cost basis which includes the portion of the purchase price payable in the future, the gain or loss from the buyer's resale would represent only the fluctuation in value occurring after the installment purchase. Thus, after the related party's resale, all appreciation has been realized within the related group at a relatively small tax cost.

The Internal Revenue Service has challenged related party installment sales under a number of theories. In some situations, the Service has advanced an assignment of income argument. In general, this argument is raised when there is a "prearranged resale" of the property by the installment buyer.[16] In other situations, the Service has made a constructive receipt argument under which the installment seller would be treated as having constructively received the proceeds from the sale. In general, this argument is raised when an escrow arrangement is involved, or where the installment seller has some measure of control or enjoyment over the proceeds from the resale of the property.[17] Another argument often urged by the Service is founded on the general rule that tax treatment should turn on the substance of a transaction rather than its form. In this vein, it is argued that the bona fides of sales between related parties should be carefully scrutinized and that, if tax avoidance is the principal objective, installment sale treatment should not be available for related party sales.

In general, the Internal Revenue Service has not been very successful in attacking related party installment sales. In the few cases in which the Service has prevailed, installment sale reporting has been denied with respect to transactions involving a controlled corporation,[18] a sale to a son where the son was forced to sell the stock sold and

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[16] See Rev. Rul. 73–157, 1973–1 C.B. 213. On the other hand, the Internal Revenue Service has agreed to treat a transaction according to its form in the case where there is a gift transfer of stock to a charity which is followed by a prearranged redemption of the donated stock, e.g., the transaction is treated as a gift followed by a sale by the charity rather than, in substance, a sale by the donor followed by a gift of the proceeds (Rev. Rul. 78–197, 1978–1 C.B. 83).

[17] See *Everett Pozzi*, 49 T.C. 119 (1967); and Rev. Rul. 73–451, 1973–2 C.B. 158.

[18] *Griffiths* v. *Helvering*. 308 U.S. 355 (1939). This case involved the creation of a corporation to receive the assignment of a settlement owed to the taxpayer with the corporation agreeing to pay the money received from the settlement to the taxpayer over a 40-year term. The Court held that there had been an anticipatory assignment of income and therefore the income was taxable to the shareholder rather than the corporation.

reinvest the proceeds in other securities held in escrow,[19] and, in the case of a sale by a husband to his wife where the Court found there was no bona fide purpose for the transaction other than tax avoidance.[20]

In the leading case, *Rushing* v. *Commissioner*,[21] the test was held to be that, in order to receive the installment benefits, the "seller may not directly or indirectly have control over the proceeds or possess the economic benefit therefrom." In this case, a sale of corporate stock was made to the trustee of trusts for the benefit of the seller's children. Since the sales were made to trusts created after the corporations had adopted plans of liquidation, the Government made an assignment of income argument. The Court upheld installment sale treatment for the stock sold to the trustee under the control or enjoyment test because the trustee was independent of the taxpayer and owed a fiduciary duty to the children. The Court rejected the assignment of income argument because it found that no income was being assigned.

The *Rushing* case has been followed in another case where the stock sold to a family trust was that of a corporation which was to be liquidated after the sale.[22] The liquidation was formally authorized after the sale to the trust. In other cases, the Tax Court has rejected the Service's substance over form and constructive receipt arguments and held that sales to a family trust qualified for installment sale reporting.[23] In the *Pityo* case, the taxpayer's wife was the beneficiary of one of the trusts to which the installment sale was made. In the *Roberts* case, the trustees were the seller's brother and personal accountant. In both cases, installment sale reporting was allowed because the Tax Court held that the trustees were independent of the seller and satisfied the *Rushing* control or enjoyment test.

In another case, installment sale reporting was allowed for a sale of marketable stock by a wife to her husband although a resale by the husband was contemplated.[24] In this case, the Court held that the husband could not be considered a mere conduit for the wife's sale of the stock since both were "very healthy economic entities" and the husband had an independent purpose for obtaining needed funds for an investment at a low rate of interest.

After achieving tax deferral and estate planning objectives through installment sales to related parties, the final objective is to avoid incurring any income tax with respect to the portion of the gain which has not been reported prior to death or before the seller wishes to make a gift transfer of the obligation. Generally, however, any "disposition" of an installment obligation will result in the recognition of any unreported gain (Code sec. 453(d)(1)). In the case of a "satisfaction" of an installment obligation at other than its face value or a sale or exchange, gain or loss results to the extent of the difference between the amount realized and the basis of the obligation. In the case where the

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[19] *Paul G. Lustgarten*, 71 T.C. 303 (1978). The Court held that the taxpayer had constructively received the proceeds from the "resale."

[20] *Phillip W. Wrenn*, 67 T.C. 576 (1976).

[21] 441 F. 2d 593 (5th Cir. 1971) *aff'g* 52 T.C. 888 (1969).

[22] *Carl E. Weaver*, 71 T.C. 443 (1978).

[23] *William D. Pityo*, 70 T.C. 225 (May 15, 1978); *Clair E. Roberts*, 71 T.C. 311 (1978).

[24] *Nye* v. *U.S.* 407 Supp. 1345, 75–1 USTC ¶ 9150 (M.D.N.C. 1975).

installment obligation is distributed, transmitted, or otherwise disposed of, gain or loss results to the extent of the difference between the fair market value of the obligation at the time of distribution, transmission or disposition, and the basis of the obligation.

These disposition rules do not apply to the transmission of installment obligations at death (Code secs. 453(d)(3) and 691(a)(4)). However, installment obligations are treated as items in respect of a decedent so that the recipient is taxed upon receipt of the installment payments in the same manner as the deceased seller would be if he had lived to receive the payments. A special rule allows a deduction for the estate taxes attributable to the unreported gain on the installment obligation.

Another provision (Code sec. 691(a)(2)) provides that the transfer of an installment obligation to the estate of the deceased seller will not be treated as a transfer requiring the reporting of gain. In addition, this rule applies to a transfer to a person pursuant to the right of such person to receive the installment obligation by reason of the death of the seller or by bequest, devise, or inheritance from the seller. Because of these rules, it has been argued that any unreported gain upon the death of the seller will never be taxed if the installment obligation is left to the obligor. In this case, it is argued that there will never be a disposition or collection of the unpaid balance because there has been a merger of interests of obligor and obligee. In other words, the obligor will have acquired a cost basis for depreciation and resale purposes prior to the seller's death but no income tax cost will have been incurred with respect to the gain unreported by the seller at the time of his death.

Based on one case, some have argued that the same result can be achieved by making gift cancellations of the obligation or of the installments as they come due. In other words, by making an installment sale and then cancelling the obligation or a number of installment payments, it is argued that the seller will incur no income tax liability, but possibly some gift taxes, and the buyer will have a cost basis in the property sold although no income tax cost will have been incurred on the transaction. If a direct gift is made, the donee's basis is generally the same as the donor's basis rather than a "cost" basis which reflects future payments which will never be made.

This cancellation technique is based on a District Court's decision in *Miller* v. *Usry*.[25] In that case, the court held that the disposition rules for obligations disposed of other than by sale or exchange were directed at corporate transfers and should not be applied to a cancellation of the obligation where there has been no actual, or real, or material gain to the taxpayer. The court did not consider the possible benefit to the donee from acquiring a cost basis through the installment sale. Next, the court held that the disposition rules for satisfaction at other than face value did apply to a cancellation but no tax was incurred because no amount was realized by the taxpayer.

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[25] 160 F. Supp. 368, 58–1 USTC ¶ 9393 (W.D. La. 1958).

B. General Issues

There are five general issues to be considered with respect to the provisions of H.R. 3899.

The first issue is whether the 30-percent initial payment limitation for real property and casual personal property installment sales should be revised or repealed.

The second issue is whether the $1,000 selling price limitation for casual sales of personal property should be revised so that gain from such sales for small amounts cannot be returned under the installment method.

The third issue is whether the requirement that a sale must be for two or more payments to qualify as an installment sale should be eliminated.

The fourth issue is whether restrictions should be provided to limit the use of installment sale reporting for sales between related parties.

The fifth issue is whether it should be clarified that the unreported gain from an installment sale is recognized by the seller's estate when the installment obligation is transferred or transmitted to the obligor of the obligation.

There are several related issues and possible alternatives the committee may wish to consider in connection with the bill; these are discussed later in E., "Alternatives and Additional Issues for Committee Consideration."

C. Description of the Bill

Explanation of provisions

Initial payment limitation

The bill would eliminate the 30-percent initial payment requirement for reporting gain on the installment method from the disposition of real property or the casual disposition of personal property. Regardless of the portion of the selling price received in the taxable year from a disposition, the income for any taxable year from a disposition is that proportion of the payments actually received in that year which the gross profit, realized or to be realized when payment is completed, bears to the total contract price. As under present law, the contract price is the portion of the selling price which is or will be paid to the seller and includes mortgage debt assumed by the buyer only to the extent in excess of the seller's adjusted basis in the property sold. The bill does not change the provisions of present law as to what constitutes payment received by the seller, including treatment of receipt of bonds or notes as payment if they are payable on demand or readily tradable. Also, sales of inventory will not be eligible for installment reporting under the provision for casual sales of personal property. Installment sales of inventoriable personal property are to be covered by the provisions relating to dealers in personal property. Although the bill refers to property (rather than only personal property) of a kind which would be included in inventory if on hand at the close of the year, it was intended that, as under present law, the inventory exception would not apply to sales of real property because real property is not generally treated as inventory for tax purposes. (Rev. Rul. 69–536, 1969–2 C.B. 109.)

Selling price limitation for casual sales of personal property

To eliminate the reporting of small amounts of gain from casual dispositions of personal property under the installment method, the bill would increase the $1,000 selling price limitation to $3,000. Thus, a casual disposition of personal property will qualify for installment method reporting only if the selling price is more than $3,000. This change is intended to eliminate the recordkeeping burdens in reporting gain for small amounts for these sales and particularly because many more small sales will be eligible for installment method reporting since the 30-percent initial payment rule is repealed by the bill.

Two payment limitation

The bill also would eliminate the requirement that a sale must be for two or more payments to qualify for installment sale reporting. Thus, under the bill, income from the sale of qualifying property for a purchase price payable in a lump sum in a taxable year subsequent to the year of sale may be reported in the year in which payment is received. The change is accomplished under the bill by defining the installment method so that the sale need not call for installment payments to qualify for installment reporting.

Sales to related parties

In addition, the bill would provide that installment reporting for dispositions of real property or casual dispositions of personal property is not allowed for a disposition directly or indirectly to a related person. For this purpose, a related person means a person bearing a relationship to the person disposing of the property which is set forth in Code sections 267(b) or 707(b)(1) which disallow losses with respect to transactions between related taxpayers. Thus, the relationships include members of a taxpayer's family, i.e., brothers and sisters, spouses, parents and grandparents, and children and grandchildren. In addition, the relationships include (1) an individual and a controlled corporation (50 percent), (2) two corporations which are 50-percent owned by the same individual, (3) a grantor and a fiduciary of any trust, (4) fiduciaries of separate trusts if the same person is a grantor of both trusts, (5) a fiduciary and a beneficiary of the trust, (6) a fiduciary of a trust and the beneficiary of another trust if the same person is a grantor of both trusts, (7) a fiduciary of a trust and a corporation controlled (50 percent) by the fiduciary or the grantor of the trust, (8) a person and a controlled charity, and (9) a partner and a controlled partnership (more than 50 percent).

Under the bill, installment sale reporting would not be denied for certain stock redemptions which are treated as sales or exchanges (Code secs. 302 and 303) rather than being treated as dividend distributions. This exception will apply even if the shareholder and redeeming corporation are considered related persons under the general rules. In the case of an installment sale redemption, no tax avoidance or deferral results from the reissuance of the redeemed stock because no gain or loss is recognized by the corporation upon receipt of money or property in exchange for its stock, including treasury stock (Code sec. 1032).

(Because it is part of a bill relating to simplification of the rules for installment sales, the bill deals with the problem in the simplest manner by denying installment sale reporting for sales between related parties. The committee may wish to consider alternatives which would limit the scope of the legislation to situations more clearly involving abuse potential although with a more complicated legislative structure. Some of the alternatives the committee may wish to consider are set forth later in this pamphlet.)

Bequests of installment obligations

Finally, the bill would provide that any previously unreported gain from an installment obligation would be recognized by a deceased seller's estate if the obligation is transferred or transmitted to the obligor of the obligation.

Effective date

In general, the provisions of the bill would be effective with respect to dispositions made after the date of enactment of the bill in taxable years ending after that date. The provision relating to transfers by reason of the death of the seller to the obligor would apply in the case of decedents dying after the date of enactment of the bill.

D. Revenue Effect

Generally, the revenue effect of H.R. 3899 is expected to be negligible. Due to the litigious nature of the issue of related party installment sales, the revenue effect for that provision is indeterminate.

E. Alternatives and Additional Issues for Committee Consideration

1. Installment sales to related parties

In dealing with potential abuses from related party installment sales, the bill adopts a simple across-the-board denial of installment sale reporting for sales between related parties. It may be argued that any restrictions should be limited to the primary abuse situation where there is a resale by the related party installment purchaser. This kind of limitation would be more complicated than an across-the-board prohibition for installment sale reporting for sales between related parties since tracing of the property sold would be necessary to determine if there had been a disposition by the installment buyer. In addition, it would be necessary to provide information reporting between the installment buyer and seller since actions by one taxpayer (the buyer) would have tax consequences for another taxpayer (the seller). However, this approach would permit installment sale reporting for situations where the purchaser is buying out the interest in a trade or business held by a related party, e.g., a son making an installment purchase from his father of a farm or other closely held business to be operated by the son.

The committee may wish to consider the following alternative approaches:

(1) Installment sale reporting could be disallowed for sales between related parties if the property sold is a marketable stock or security (or if the purchaser is a family trust) but this general disallowance rule would not apply to sales of other types of property (or to other related persons). In the case of other types of property, the seller could be considered to have disposed of the installment obligation (and therefore unreported gain would be recognized) if the related party purchaser disposes of the property purchased on the installment basis during the term of the installment obligation. Special rules could be provided so that a disposition of the installment obligation would not occur in the case of a sale of an unincorporated farm or other business with respect to resales of only a portion of the business assets (e.g., the rules could be similar to the provisions for acceleration of extended payments of estate taxes attributable to a closely held business when a certain percentage of the value of the interest is disposed of or assets above that level are withdrawn from the business).

(2) Another alternative could be the same as under (1) for marketable stocks and securities but, for sales of other property, a definite period, say from 2 to 3 years, could be prescribed for determining if there is a resale by the related party purchaser which will result in disposition treatment of the installment obligation and gain recognition for the original seller. A 2-year period for the resale test would be consistent with the period prescribed for special treatment for gain on

property transferred to a trust at less than fair market value (Code sec. 644).

(3) A third alternative could be to provide a specific testing period, such as 2 to 3 years, for determining if there had been a resale of any type of property (including marketable securities) purchased on the installment basis from a related party. If a resale was made within the prescribed period, it would constitute a proportionate disposition of the installment obligation by the original seller.

2. Method of election

The committee may wish to consider issues relating to the election of installment sale reporting. Under present law, an election can be made to report gain from an installment sale on a timely filed return, a delinquent return, or on an amended return for the year of sale not barred by the statute of limitations if the facts indicate no election inconsistent with the installment election had been made with respect to the sale (Rev. Rul. 65–297, 1965–2 C.B. 152). In the case where a return is filed which reports the entire gain in gross income from an installment sale, an amended return or claim for refund cannot be used to elect installment sale reporting for the sale because the election to report the gain in full is treated as a binding election.[26]

It has been recommended that the installment method of reporting gain should apply automatically to any gain from a qualifying sale by a cash-basis taxpayer who does not elect otherwise.[27] In addition, it might be necessary to specify that elections are to be irrevocable at some point in time before the statute of limitations on the assessment of deficiencies has run.

The suggested change might alleviate a whip-saw problem for the Internal Revenue Service, e.g., where the taxpayer does not report gain from a sale for the year of sale but elects installment treatment if the omission is discovered on audit or, if the statute of limitations has run, contends that the full amount of gain should have been reported for the year of sale.

In terms of simplification aspects, the suggested change would eliminate a trap that might arise because the election to report gain from a qualifying sale is improperly made. On the other hand, the existence of a choice to report the full gain or use the installment method would continue to require an evaluation of whether to exercise the election, e.g., it may be preferable to report the entire gain for a qualifying sale because of the rate bracket a taxpayer is in for the year of sale or because it may be offset against losses from other transactions.

3. Sales subject to a contingency

The committee may wish to consider the issue of eligibility for installment sale reporting in cases where the selling price is subject to a contingency.

As a general rule, installment reporting of gain from deferred payments is not available where all or a portion of the selling price is

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[26] *Robert F. Koch,* T.C. Memo 1978–271; *Pacific National Co.* v. *Welch,* 304 U.S. 191 (1938).

[27] Recommendation number 1978–15 of the Tax Section of the American Bar Association. 32 *Tax Lawyer* 231 (1978).

subject to a contingency. The case law holds that the selling price must be fixed and determinable for section 453(b) to apply.[28] An agreement, however, to indemnify the purchaser for breach of certain warranties and representations by offset against the purchase price will not disqualify an installment sale under section 453(b).[29] Exactly how broad such contingencies can be is unclear.

Where an installment sale is subject to a contingency with respect to the price and the installment method is not available, the taxpayer is required to recognize all of the gain in the year of the sale with respect to all of the payments to be made, even though such payments are payable in future taxable years. In the case of a cash-method taxpayer where the future payments have no readily ascertainable fair market value, this taxpayer may treat the transaction with respect to those payments as "open" and use the cost-recovery method under *Burnett* v. *Logan*, 283 U.S. 404 (1931).

It is well settled that renegotiation of the original contract price in a subsequent year does not affect the prior election to use the installment method of reporting, but only adjusts the remaining gross profit to be realized in subsequent years.[30] Rev. Rul. 72–570 states that the gross profit to be reported, as adjusted for the renegotiation between the parties, is spread over the adjusted payments during the remaining life of the notes. Under Rev. Rul. 77–56, *supra*, the same rule applies in the indemnity-contingency case where the contingency operates and the gain from the installment sale must be recomputed. The income tax returns for the previous taxable years are not affected in the renegotiation and indemnity situations, and it therefore follows that if the taxpayer has reported more gain in the previous taxable years than his total gain, as recomputed, he must deduct the excess as a loss in the taxable year of the recomputation.

Some have suggested that installment reporting of gain from deferred payments should be allowed in all cases where the selling price is subject to a contingency, if the contract provides for a maximum selling price which would include the contingent portion of the price. The maximum selling price would provide an objective basis on which to apply the installment provisions. This price would be determined from the "four corners" of the contract agreement as the largest price which could be paid to the taxpayer assuming all contingencies, formulas, etc., operate in the taxpayer's favor.

Income from the sale would be reported on a pro rata basis with respect to each installment payment using the maximum selling price to determine the total contract price and gross profit ratio.

If it is subsequently determined that the contingency will not be satisfied in whole or in part, thus reducing the maximum selling price, the taxpayer's income from the sale would be recomputed. The taxpayer would then report reduced income, as adjusted, with respect to each installment payment received in the taxable year of adjustment and subsequent taxable years. If the maximum price is reduced in

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[28] *Gralapp* v. *United States*, 458 F.2d 1158 (10th Cir. 1972); *In re Steen*, 509 F.2d 1398 (9th Cir. 1975).

[29] See Rev. Rul. 77–56, 1977–1 C.B. 135.

[30] See *Dalriada Realty Co.*, 5 B.T.A. 905 (1962), *acq.* VII–1 C.B. 8; *J. P. Jerpe*, 45 B.T.A. 199 (1941), *acq.* 1942–1 C.B. 9; Rev. Rul. 72–570, 1972–2 C.B. 241.

more than one taxable year, *e.g.*, because of successive changes in the status of the contingency, each such year of reduction would constitute an adjustment year.

Where the taxpayer has reported more income from installment payments received in previous taxable years than the total recomputed income, the taxpayer would be permitted to deduct the excesses in the adjustment year as a loss.

4. Open transactions

In the case of a sale which would be considered to be an open transaction because the buyer's obligation to pay does not have an ascertainable fair market value, some have suggested that basis should be recovered on a pro rata basis whenever the term for payment is fixed by the contract. As a result, the selling taxpayer could not recover basis before reporting any gain from the sale, therefore making the tax treatment essentially the same as under the installment method of reporting for sales having a fixed selling price and term for payment. Transactions which were not for a fixed selling price or fixed term would be subject to special rules.

The simplification aspects of the proposal would primarily relate to lessening the possibility of controversy between taxpayers and the Internal Revenue Service over treating a transaction as an open one. However, there would continue to be an incentive for the IRS to resist open transaction treatment for sales of capital assets because, if the transaction is considered closed in the year of sale, amounts received in excess of the valuation placed on the buyer's promise to pay would be treated as a collection gain subject to ordinary rates. On the other hand, the possibility of collection gain arising could induce taxpayers to elect installment sale reporting, if allowed, with ratable basis recovery and avoid the valuation and cash equivalency issues which would arise in connection with arguing for open transaction treatment. Thus, on balance, it is at least arguable that a pro rata basis recovery rule might contribute to simplification by minimizing controversy presently arising with respect to open transaction treatment.

5. Installment obligations distributed in a 12-month corporate liquidation

Under present law, gain or loss is not generally recognized at the corporate level for sales and exchanges occurring during the 12-month period after the corporation has elected a plan of liquidation (Code sec. 337). A special rule provides that in this situation gain or loss generally is not recognized to the liquidating corporation for distributions of installment obligations (Code sec. 453(d)(4)(B)). Gain or loss is recognized by the shareholders with respect to the liquidating distributions. No special exception applies for the distribution of installment obligations to shareholders so that the shareholders can defer reporting gain from the obligations.

Some have suggested that, in connection with a 12-month liquidation, the shareholders should step into the shoes of the corporation and report gain from installment obligations as payments are received. The suggestion is based primarily on equity or ability to pay concepts rather than simplification objectives. The implementation of the suggestion could lead to some complexity since it would be necessary to allocate a shareholder's basis in stock between installment obligations and other property received.

6. Cancellation of installment obligations

As noted earlier, one court has held that a cancellation of an installment obligation does not constitute a disposition which triggers recognition of unreported gain.[31] The result under this case has been cited as constituting a method by which the basis rules for a gift (sec. 1015) can be circumvented without incurring any income tax since the donee would have a cost basis through an installment purchase.

Some have suggested that it should be made clear that a cancellation of an installment obligation is to be treated as a disposition of the obligation. Such a change would contribute to simplification in the sense that the law would be clarified.

7. Receipt of like kind property as payment

Under present law, the transfer of property for cash payments and like kind property may qualify both for installment sale reporting and, with respect to the gain attributable to the like kind exchange, nonrecognition treatment (Code sec. 1031 and Rev. Rul. 65–155, 1965–1 C.B. 356). In this case, the gain to be recognized under installment method reporting is the total gain realized on the transaction less the gain eligible for nonrecognition under the like kind exchange provision. However, the value of the like kind property received by the seller is taken into account in determining the amount of the selling price, the contract price, and payments received for purposes of the installment sale provision.[32]

It has been argued that taking the value of the like kind property into account for these purposes results in the acceleration of recognition of gain in a way that is contrary to the basic purpose of installment sale reporting, i.e., gain should be recognized as the cash payments, with which income taxes are to be paid, are received.

This issue may be illustrated by the following example. Assume that the taxpayer exchanges property with a basis of $100,000 for like property worth $200,000 and an installment obligation for $800,000 with $100,000 payable in the taxable year of the sale and the balance payable in the succeeding taxable year. Depending on whether the value of the like kind property is taken into account, the installment sales computations are as follows:

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[31] *Miller* v. *Usry*, 160 F. Supp. 368. 58–1 USTC ¶ 9393 (W.D. La. 1958).

[32] Rev. Rul. 65–155, 1965–1 C.B. 356; *Clinton H. Mitchell*. 42 T.C. 953, 965 (1964); *Albert W. Turner*, TC Memo 1977–437. Similar computations are made when a portion of a gain from the installment sale of a principal residence is not required to be recognized because of reinvestment of sales proceeds in a new principal residence (Code sec. 1034) or because of the exclusion for sales by elderly taxpayers (Code sec. 121). See Rev. Rul. 75, 1953–1 C.B. 83.

	Rev. Rul. 65–155—amount taken into account (a)	Like property not taken into account (b)
Selling price:		
Installment obligation	$800,000	$800,000
Value of like property	200,000	
Selling price	1,000,000	800,000
Less: Basis of property exchanged	100,000	
Gain realized	900,000	800,000
Less: Gain attributable to like kind exchange	100,000	
Gain to be recognized	800,000	800,000
Contract price	1,000,000	800,000
Gross profit ratio (percent)	80	100
Gain to be reported for:		
1. Taxable year of sale:		
(a) 80% of $300,000 (payments "received" of $100,000 cash and $200,000 value of like property)	240,000	
(b) 100% of $100,000 (cash payments)		100,000
2. Succeeding taxable year:		
(a) 80% of $700,000 (cash received)	560,000	
(b) 100% of $700,000 (cash received)		700,000
Total gain recognized	800,000	800,000

In this example, some would argue that the approach under which the value of like property is not taken into account is more consistent with the basic objectives of installment sale reporting because gain is recognized as cash payments are actually received.[33]

8. Installment sales by executors

Under present law, the transmission of an installment obligation at death is not treated as a disposition triggering recognition of any re-

[33] Special rules would be necessary for allocating basis for a transaction in which the basis of property transferred exceeded the value of like property received.

maining unreported gain (Code secs. 453(d)(3) and 691(a)(2)). In addition, no disposition of the installment obligation occurs by reason of a transfer to a person pursuant to a right to receive amounts by reason of the death of the decedent or by bequest, devise, or inheritance from the decedent (Code sec. 691(a)(2)). The recipient of the installment obligation takes the place of the decedent for purposes of reporting gain as the payments are received (Code sec. 691(a)(4)). An income tax deduction for the estate tax attributable to the unreported gain is allowable to the recipient who must include the gain in his gross income (Code sec. 691(c)).

These provisions apply only with respect to installment sales which had been made by the decedent. They do not apply with respect to installment sales made by an executor who then distributes the obligation rather than the property to the decedent's beneficiaries.

Some have suggested that rules similar to those applicable to predeath installment sales should apply to post-death sales by an executor (or by a trustee of a trust used as a will substitute, e.g., a revocable trust). Thus, the executor (or trustee) could sell assets on the installment method and then make a tax-free distribution of the obligation to the beneficiaries who would report gain as the installment payments are collected. It is argued that this treatment would facilitate the administration of estates. It would provide consistent treatment for transactions which are substantively the same although different in form, i.e., the same treatment would apply for sales of an executor followed by a distribution of the obligation as now applies for cases where the executor first distributes the property which is then sold on the installment basis by the beneficiaries.[34]

9. Installment sales by a grantor trust

Under present law, the income of a trust is taxed to the grantor if certain rights, powers, and interests are retained by the grantor (Code sec. 671 et seq.). For estate tax purposes, all or a portion of the value of the trust's property is includible in the grantor's gross estate if certain rights, powers, and interests are retained by the grantor (Code sec. 2036 et seq.) Although there may be no Federal tax advantages if the income of a trust is taxed to the grantor and the trust corpus is includible in the gross estate, trust conveyances are sometimes made for nontax reasons, e.g., a revocable trust may be used as a will substitute to avoid probate expenses and administration.

Even though the separate trust entity generally is ignored in practical result for income and estate tax purposes, the Court of Claims recently held that the trust entity must be recognized in determining if a deduction was allowable under Code section 691(c) for the estate taxes attributable to the gain which had not been reported by the grantor at death with respect to an installment obligation included in the grantor's gross estate and arising from a sale made by the trust prior to the grantor's death.[35]

It has been argued that this result should be reversed so that the grantor would be treated as the owner of the installment obligation

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[34] Regulations would provide any necessary coordination with the estate and trust distribution rules.

[35] *Sun First National Bank of Orlando* v. *United States*, 587 F.2d 1037 (Ct. Cl. 1978).

included in the trust corpus for purposes of the estate tax deduction for income in respect of a decedent. It is argued that this approach would be consistent with the general provision under which the grantor is treated as the owner of the trust corpus for income and estate tax purposes. In addition, it is argued that this change is necessary to prevent the combined income and estate taxes on the gain from reaching confiscatory levels, i.e., the estate tax rate could be as high as 70 percent and, for a capital gain, the recipient would be subject to an effective income tax rate of up to 28 percent.[36]

10. Foreclosure on installment obligations

Under present law, the recognition of gain upon a reconveyance of real property to the seller in partial or full satisfaction of purchase money debt is limited (Code sec. 1038). Losses, including bad debt losses, are also not recognized upon a reconveyance of real property. With respect to gains, the amount of gain required to be recognized upon reconveyance of the real property sold generally is limited to the lesser of the amount of any remaining unreported portion of the original gain or the amount by which the sum of the money and fair market value of property received prior to the reacquisition exceeds the amount of gain previously reported. The Internal Revenue Service has ruled that this provision does not apply to a reconveyance to the estate of a deceased taxpayer who made the original sale (Rev. Rul. 69–83, 1969–1 C.B. 202). In other words, a decedent's estate is not permitted to succeed to the benefits which would have been available to the decedent had he lived to receive the reconveyance because the estate is considered to be a separate taxable entity.[37]

It has been argued that a decedent's estate should succeed to the decedent's right to qualify for the limitation on recognition of gain upon reconveyance of real property in full or partial satisfaction of indebtedness arising from a sale which had been made by the decedent.

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[36] It will also be necessary to revise the installment obligation disposition rules if the trust is to be permitted to make a nontaxable distribution to a beneficary who would report the installment gain as payments are received. See Rev. Rul. 55–159, 1955–1 C.B. 391; and *H.F. Shannon*, 29 T.C. 702 (1958). Transfers of an installment obligation to a grantor trust have also been held to constitute a taxable disposition. *Elizabeth J. Marshall* v. *United States*, 26 F. Supp. 580 (S.D. Cal. 1939). Coordination with trust distribution rules might also be necessary if the grantor trust entity is to be ignored for all installment obligation disposition rules.

[37] In Revenue Ruling 77–322, 1977 C.B. 296, the Internal Revenue Service ruled that an estate may utilize the provisions of Code section 1341 in computing its tax when it restores an item that was previously included in income by the decedent under a claim of right. In permitting the estate to step into the shoes of the decedent for this purpose, the Service revoked an earlier position to the contrary stated in Revenue Ruling 67–355, 1967–2 C.B. 296. The Service had lost the two cases in which it had asserted the 1967 ruling.

F. Departmental Position

The Treasury Department believes that the complexity in the installment sale area arises not only from the provisions regarding the installment method of reporting but also from the lack of a coordinated taxing structure for all sales for future payments. Accordingly, Treasury recommends that Congress take this opportunity to provide consistency of treatment and clarity of rules for all sales for future payment.

Specifically, Treasury recommends the adoption of a general rule requiring taxpayers to recover basis ratably over the term of any deferred payment sale where recognition of gain is deferred. This requirement would eliminate the greatest causes of complexity in the deferred payment area, e.g., whether a transaction is "open" or "closed", and whether a promise of future payment has "no ascertainable fair market value". Moreover, it would remove the incentive to structure transactions artificially in an effort to achieve full basis recovery prior to the recognition of any gain.

If both the general rule suggested above and an effective rule to eliminate manipulation of the deferred tax payment privilege through sales to related parties are adopted, Treasury would support the elimination of the 30-percent initial payment limitation. Treasury also supports the elimination of the two payment requirement and that section of the bill relating to dispositions of installment obligations to the obligor. Treasury is, however, opposed to increasing the $1,000 selling price exception for causal dispositions of personal property to $3,000. Treasury recommends that the exception be eliminated from the bill.

In addition to the foregoing, Treasury recommends that: (1) ratable recognition of gain be the general rule applicable to deferred payment sales unless the taxpayer affirmatively elects otherwise; (2) subject to the resolution of technical problems, the value of the like kind property received in a deferred payment sale not be taken into account in determining selling price, contract price, or payments received; (3) the deferred tax payment privilege be extended to installment obligations distributed in 12-month corporate liquidations; (4) in general, sales of marketable securities would be ineligible for the deferred tax payment privilege; (5) sales between related parties be subject to a special rule under which, in general, a disposition by the purchaser, within two years of the original sale, of property purchased for deferred payments is treated as a disposition of the deferred payment obligation held by the seller; (6) section 453(d) be clarified to provide that the cancellation of an installment obligation is treated as a disposition; (7) an executor (or trustee of a testimentary trust or trust used as a will substitute) be permitted, for 2 years after he decedent's death, to sell property included in the decedent's gross estate for deferred payment and distribute the deferred payment obligation without acceleration of the deferred gain; (8) the deduction for estate tax attributable to items of income in respect of a decedent be allowed to a trust holding deferred payment obligations included in the estate of a decedent; (9) the amount realized upon the bargain sale of a deferred payment obligation be equal to the fair market value of the obligation, and (10) a decedent's estate be permitted to qualify for section 1038 treatment where a qualifying sale had been made by the decedent.

III. DESCRIPTION OF H.R. 3900

(Messrs. Ullman and Conable)

SIMPLIFICATION OF CERTAIN PROCEDURE AND ADMINISTRATION PROVISIONS

A. Payment of Interest on Wrongful Levies (sec. 2 of the bill and sec. 6343(b) of the Code)

Present law

Under present law, two remedies are provided for third-party owners whose property is wrongfully seized by the Internal Revenue Service for the collection of a delinquent taxpayer's liability. In general, one remedy provides an administrative procedure for the return of the property wrongfully seized (sec. 6343(b)), and the other authorizes a civil action for an injunction, the return of the property wrongfully seized, or the proceeds from the sale of the property (sec. 7426).

Under the administrative procedure, the Internal Revenue Service is authorized to return property (or the proceeds from the sale of the property) to a person when it determines that the levy was wrongful (sec. 6343(b)). Where the Service returns the property or proceeds under the administrative procedure, a person whose property was wrongfully seized is not entitled to the payment of interest for the period the Government held the property or the proceeds therefrom.

On the other hand, the payment of interest is provided if the third party prevails under the judicial remedy (sec. 7426(g)).[1]

Under this provision, interest accrues from the date the Service receives money wrongfully levied upon (or the date of the sale of property wrongfully levied upon) until the date the judgment is paid. The interest is payable at the rate generally established to be paid on the overpayment of taxes (sec. 6621). (Currently, the rate is 6 percent per annum.)

Issue

The issue is whether interest should be payable where it is administratively determined by the Internal Revenue Service that a wrongful levy of property has been made and money is returned to the owner of the property by the Service.

Explanation of provision

The bill would provide for the payment of interest to a person under the administrative procedure for wrongful levies. Under rules

[1] The general provision for payment of interest on a judgment for the overpayment of taxes is sec. 2411 of title 28 of the United States Code. The rate of interest under this provision is determined by reference to section 6621 of the Internal Revenue Code of 1954.

similar to those in the interest provisions for the judicial remedy, interest would be paid if money is wrongfully seized or if the proceeds from a sale of the property are returned to the owner of the property. The rate of interest would be determined under the general provision for the payment of interest on overpayments of tax. In the case of a seizure of money, the period for the payment of interest begins with the date the money is seized and ends when the money is returned. In the case of a payment of the proceeds from the sale of property wrongfully seized, the period for the payment of interest begins with the date of sale of the property and ends when the payment to the owner is made.

Effective date

This provision would apply to levies made after the date of the enactment of the bill.

Departmental position

The Treasury Department supports this provision, but recommends that the provision be amended to provide that interest be paid for the period described in Code section 6611(b)(2).

Prior Congressional action

This provision was included in a bill, H.R. 12578, passed by the House in the 95th Congress, but was not acted upon by the Senate Finance Committee or considered by the Senate.

B. Repeal of Requirement that Transferors of Certain Property to Exempt Organizations Must File Returns (sec. 3 of the bill and sec. 6050 of the Code)

Present law

Under present law, a person who transfers income-producing property valued at over $50,000 (without regard to any lien thereon) to an exempt organization must file a return (Form 4629) if the transferor knows the recipient is the type of organization subject to tax on its unrelated business income (sec. 6050). The regulations require that the return show a description of property transferred, the date of transfer, the fair market value of the property (without regard to any lien thereon) on that date, and the amount of any mortgage or similar lien on the property immediately after the transfer. This return requirement was added by the Tax Reform Act of 1969.

Under present law, the Internal Revenue Service can require an exempt organization to maintain records and furnish information with respect to transfers of income-producing property to it (secs. 6001 and 6033). Thus, the information now required to be furnished by the transferor may also be furnished by the transferee exempt organization.

Issue

The issue is whether the reporting requirement for transferors of property to exempt organizations is unnecessary and should be repealed.

Explanation of provision

The bill would repeal the requirement that transferors file an information return with respect to transfers to an exempt organization.

Effective date

The provision would apply to transfers of property made after the date of enactment of the bill.

Departmental position

The Treasury Department supports this provision.

Prior Congressional action

This provision was included in a bill, H.R. 12578, passed by the House in the 95th Congress, but was not acted upon by the Senate Finance Committee or considered by the Senate.

C. Simplification of Private Foundation Return and Reporting Requirements (sec. 4 of the bill and secs. 6033, 6034, and 6056 of the Code)

Present law

Present law requires the foundation managers of every private foundation having at least $5,000 of assets to file an annual report (sec. 6056). The report (Form 990–AR) is to contain the foundation's gross income, expenses, disbursements, balance sheet, total amount of contributions and gifts received by it during the year, an itemized list of all grants or contributions made or approved, the names and addresses of the foundation managers, and a list of those foundation managers who are substantial contributors or own certain interests in businesses in which the foundation owns an interest. This report must be made available for public inspection at the principal office of the foundation (sec. 6104(d)) and is open to public inspection at the office of the Internal Revenue Service (sec. 6104(b)). In addition, the report must be furnished to the appropriate State officials (sec. 6056(d)).

Under present law, exempt organizations described in section 501 (c)(3) of the Code (including exempt private foundations) must file an annual information return (sec. 6033). Under this provision, the return in the case of foundations (Form 990–PF) must state items of gross income, etc., and such other information as may be required by the forms and regulations. At present, this return contains most of the information required in the annual report of the foundation managers. This annual information return is also open to public inspection at the offices of the Internal Revenue Service (sec. 6104(b)). In addition, a copy of this return must be attached to the annual report of a private foundation when the report is furnished to the appropriate State officials (Regs. sec. 1.6056–1(b)(3)). Thus, information furnished on a foundation manager's report (Form 990–AR) substantially duplicates or overlaps the return filed by the foundation (Form 990–PF) in content and availability for public inspection.

Under present law, trusts which have solely charitable beneficiaries but which are not exempt from taxation (sec. 4947(a)(1) trusts) are subject to different return and disclosure requirements from those applicable to exempt charitable trusts and organizations. A nonexempt charitable trust is not required to file an annual information return, open to public inspection. Instead, this type of trust is required to file an income tax return (Form 1041) under section 6012 if its gross income for the year is at least $600 or if it has any taxable income (except that Form 1041 need not be filed by a nonexempt charitable trust which is a private foundation and which has no taxable income for the year); these tax returns are not open to public inspection. In addition, a nonexempt charitable trust, other than one which is required to distribute all its net income currently, must file an annual information return (Form 1041–A), open to public inspection, setting forth certain information concerning its charitable contributions, income and expenses, and balance sheet items, but not containing all of the information required of exempt charitable trusts (sec. 6034). If a nonexempt charitable trust is a private foundation, it also must file a return (pursuant to the regulations under sec. 6011) setting forth much of the information contained on an exempt organization's information return, but this return (Form 5227) is not open to public inspection. In addition, a nonexempt charitable trust which is a private foundation must file the annual report (Form 990–AR or an equivalent report), which is open to inspection and must be furnished to the appropriate State officials as in the case of exempt private foundations, if the trust has at least $5,000 of assets.

Issues

One issue is whether the private foundation reporting requirements should be simplified by combining the annual return (Form 990–PF) and annual report (Form 990–AR) into a single annual return containing the information presently required on each of the two separate forms.

Another issue is whether nonexempt charitable trusts described in section 4947(a)(1) of the Code should be required to report the same information and be subject to the same disclosure requirements as exempt charitable organizations.

A further issue is whether the disclosure of the name and address of indigent or needy persons receiving grants of less than $1,000 in any year should no longer be required.

Explanation of provision

The bill would eliminate the requirement (under sec. 6056) that the managers of a private foundation with assets of $5,000 or more must file an annual report (Form 990–AR) in addition to an annual information return. Instead, the bill would require that the information currently required to be furnished on the annual report (Form 990–AR) but not on the information return (Form 990–PF) be furnished instead on a single annual information return (under sec. 6033). The annual information return would be subject to public inspection at the foundation's office and would be required to be furnished to the appropriate State officials under the same conditions now applicable to the annual report, and would be available for public inspection at the offices of the Internal Revenue Service as under present law.

The bill also provides that the return would not be required to list the name and address of a needy or indigent recipient (other than a disqualified person) of a gift or grant made by the foundation if the total of the gifts or grants received by the person during the year from the foundation did not exceed $1,000.

Under the bill, the section 6033 information reporting requirements and the disclosure of the information reported would apply to nonexempt charitable trusts described in section 4947(a)(1) as well as to exempt charities. If the nonexempt charitable trust is a private foundation, the trust's information return would be required to contain all the information required of an exempt private foundation and the trust would not be required to file a separate annual report. In addition, nonexempt trusts would no longer be required to file a Form 1041–A (under sec. 6034).

Effective date

This provision would apply to taxable years beginning after December 31, 1979.

Departmental position

The Treasury Department supports this provision. The Treasury recommends that this proposal, which simplifies the reporting requirements of private foundations and nonexempt charitable trusts, be expanded to include provisions to simplify the reporting requirements of charitable split interest trusts described in section 4947(a)(2) of the Code. Presently such trusts may file as many as three returns which are substantially duplicative. Simplification and consolidation would be of benefit both to the Treasury Department and to fiduciaries administering such trusts.

Prior Congressional action

This provision was included in a bill, H.R. 12578, passed by the House in the 95th Congress, but was not acted upon by the Senate Finance Committee or considered by the Senate.

This provision is also included in a bill, H.R. 4746, the provisions of which were approved by the Subcommittee on Select Revenue Measures on July 10, 1979.

D. Repeal of Addition to Tax in the Case of Certain Jeopardy Assessments (sec. 5 of the bill and sec. 6658 of the Code)

Present law

Under present law, if the Internal Revenue Service determines that the collection of tax is in jeopardy, an assessment and collection of that tax may be made without resorting to the normal time-consuming assessment and collection procedures. For this purpose, there are two basic types of special assessments—termination assessments (sec. 6851) and jeopardy assessments (secs. 6861 and 6862). The termination assessment is limited to the assessment of the income tax when the collection of the income tax is in jeopardy before the end of the taxpayer's normal tax year or before the due date of the return. In other income tax cases and in all cases involving other taxes, the jeopardy assessment procedures are used.

The Code (sec. 6658) provides an addition to tax equal to 25 percent of the amount of tax where a taxpayer violates or attempts to violate the termination assessment provision. No similar penalty applies to jeopardy assessments.

Issue

The issue is whether the addition to tax for a violation, or attempted violation, of the termination assessment provision should be repealed.

Explanation of provision

The bill would repeal the 25-percent addition to tax penalty with respect to termination assessments.

Effective date

This provision would apply to violations (or attempted violations) occurring after the date of the enactment of this bill.

Departmental position

The Treasury Department supports this provision.

E. Repeal of Requirement That Information be Furnished to the Internal Revenue Service in Connection with Certain Stock Options (sec. 6 of the bill and sec. 6039 of the Code)

Present law

Under present law, an annual information return (Form 3921) is required to be filed with the Internal Revenue Service by a corporation which transfers a share of stock to any person pursuant to his exercise of a qualified stock option (described in sec. 422) or restricted stock option (sec. 424).[1] In addition, a return (Form 3922) is required to be filed by every corporation that records (or has its agent record) a transfer of stock which was acquired through the exercise either of an option granted under an employee stock purchase plan (sec. 423) at an exercise price between 85 percent and 100 percent of the stock's value as of the time of the grant of the option, or through the exercise of a restricted stock option (sec. 424) at an exercise price between 85 percent and 95 percent of the value of the stock as of the time of the grant of the option. (Under each of these sections, a portion of the sales price for the stock is treated as ordinary income.)

A written statement concerning information relating to these transfers must also be furnished to the persons listed on the return prior to January 31 of the year following the calendar year covered by the return.

Issue

The issue is whether the requirement that the information relating to certain stock options be furnished to the Service should be repealed.

Explanation of provision

The bill would repeal the requirement that information relating to certain stock options be furnished to the Internal Revenue Service.[2]

Effective date

This provision would apply with respect to calendar years beginning after 1979.

Departmental position

The Treasury Department supports that part of the section which eliminates the requirement that corporations file a return with the Internal Revenue Service. However, section 6 also eliminates the requirement that the corporation furnish information to a person who exercises a restricted stock option. Treasury understands that there are

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[1] Under a provision added by section 603 of the Tax Reform Act of 1976, options exercised after May 20, 1981, will no longer be treated as qualified or restricted stock options.

[2] No provision is made for the furnishing of information relating to the exercise of a restricted stock option since the term of these options cannot exceed ten years and must have been issued pursuant to a contract or plan adopted before 1964. However, under transitional rules, restricted stock options might be exercised until May 20, 1981.

still some restricted stock options outstanding. Since the information the corporations presently furnish is needed by the option holder to establish basis when the stock is later disposed of, Treasury recommends that the provision be amended to provide that this information be continued to be furnished to individuals who exercise restricted stock options.

F. Time for Filing Certain Gift Tax Returns (sec. 7 of the bill and sec. 6075(b) of the Code)

Present law

Under present law, a gift tax return, if required, is due on or before the 15th day of the second month following the close of the calendar quarter. Quarterly returns are required when all taxable gifts made during a calendar year exceed $25,000. Where all transfers made in a calendar year which are subject to the gift tax filing requirements do not exceed $25,000 in taxable gifts, a return need be filed only by the filing date for gifts made during the fourth calendar quarter of the calendar year (i.e., February 15 of the following year).

On the other hand, an individual's income tax return is due on or before the 15th day of the fourth month following the close of the taxable year. For the calendar year taxpayer, a return is due on or before April 15. In addition, the Internal Revenue Service may grant an extension of time for filing a return. Presently, the Service grants an automatic 2-month extension for individuals upon timely application and payment of the estimated tax due.

Because the filing date for the gift tax return is earlier than the due date of an individual's income tax return, a timely gift tax return cannot be filed for a taxable gift if the obligation to file a gift tax return is discovered during a review of the taxpayer's financial transactions in connection with the preparation of his income tax return. Conformity of filing dates would allow a taxpayer's advisors to review his annual transactions at one time to prepare both the gift and income tax returns.

Issues

One issue is whether the due date of the gift tax return for the fourth calendar quarter or calendar year should be postponed from February 15 to April 15. Another issue is whether an extension of time for filing an income tax return should serve as an automatic extension of time for filing the fourth calendar quarter or annual gift tax return.

Explanation of provision

The bill would provide that the due date for the fourth calendar quarter or annual gift tax return is April 15. In addition, the bill would provide that an extension for filing the income tax return of a calendar year taxpayer would automatically extend the time for filing the fourth quarter or annual gift tax return.

Effective date

The provision would apply to gift tax returns for calendar years ending after the date of enactment of this bill.

Departmental position

The Treasury Department does not oppose this provision.

G. Disclosure of Manufacturers Excise Taxes to State Officials (sec. 8 of the bill and sec. 6103 of the Code)

Present law

Under present law, returns and return information relating to specified Federal taxes can be disclosed to State tax officials for the purpose of, but only to the extent necessary in, the administration of State tax law (Code sec. 6103). However, the taxes imposed by chapter 32 of the Code (i.e., the manufacturers excise taxes) were omitted in the Tax Reform Act of 1976 disclosure amendments from the list of taxes with respect to which information can be disclosed to State officials.

Issue

The issue is whether returns and return information regarding the manufacturers excise taxes imposed under chapter 32 of the Code should be disclosable to State tax officials for purposes of administering State tax laws.

Explanation of provision

The provision would include returns and return information regarding the manufacturers excise taxes imposed under chapter 32 of the Code among the returns and return information which are authorized to be disclosed to State tax officials.

Effective date

The provision would be effective on the date of enactment of the bill.

Departmental position

The Treasury Department supports this provision.

H. Revenue Effect

The provisions contained in H.R. 3900 would not have any significant revenue effect in the current fiscal year or in any of the five following fiscal years.